



STATE BOARD OF EQUALIZATION

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Fourth District, Los Angeles

JOHN CHIANG  
State Controller

RAMON J. HIRSIG  
Executive Director

January 6, 2010

Dear Interested Party:

Enclosed is the Discussion Paper regarding proposed Regulation 4076, *Wholesale Cost of Tobacco Products* under the Cigarette and Tobacco Products Tax Law. Discussion regarding proposed Regulation 4076 is scheduled for the Board's **March 23, 2010, Business Taxes Committee (BTC)** meeting. The discussion paper is also posted online at the BTC webpage at <http://www.boe.ca.gov/meetings/btc2010.htm>.

However, before the issue is presented at the BTC meeting, staff would like to provide interested parties an opportunity to discuss the issue and present any suggested changes or comments. Accordingly, a meeting is scheduled in **Room 122 at 10:00 a.m. on January 20, 2010**, at the Board of Equalization, 450 N Street, Sacramento, California.

If you are unable to attend the meeting but would like to provide input for discussion at the meeting, please feel free to write to me at the above address or send a fax to (916) 322-2958 before the January 20 meeting. If you are aware of other persons who may be interested in attending the meeting or presenting their comments, please feel free to provide them with a copy of the enclosed material and extend an invitation to the meeting. If you plan to attend the meeting on January 20, or would like to participate via teleconference, I would appreciate it if you would let staff know by contacting Mr. Phil Bishop at (916) 327-6440 or by e-mail at [Phil.Bishop@boe.ca.gov](mailto:Phil.Bishop@boe.ca.gov) prior to January 15, 2010. This will allow staff to make alternative arrangements should the expected attendance exceed the maximum capacity of Room 122 and to arrange for teleconferencing. In addition, please let Phil Bishop know if you wish to have future correspondence, including the issue paper and all attachments, sent to your mailing address rather than to your e-mail address.

Whether or not you are able to attend the above interested parties' meeting, please keep in mind that the due date for interested parties to provide written responses to staff's analysis is February 10, 2010. Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, please ensure your comments do not contain confidential information.

Thank you for your consideration. I look forward to your comments and suggestions. Should you have any questions, please feel free to contact Ms. Leila Hellmuth, Supervisor, Business Taxes Committee Team at (916) 322-5271.

Sincerely,



Lynn Bartolo, Chief  
Excise Taxes Division  
Property and Special Taxes Department

LB:cj

Enclosures

cc: (all with enclosures)

Honorable Betty T. Yee, Chairwoman, First District (MIC 71)  
Honorable Jerome E. Horton, Vice Chair, Fourth District (MIC 72)  
Honorable Bill Leonard, Member, Second District (MIC 78)  
Honorable Michelle Steel, Member, Third District (MIC 77)  
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel (via e-mail)

Via email:

Mr. Alan LoFaso, Board Member's Office, First District	
Mr. Gary Qualset, Board Member's Office, First District	
Mr. Doug Anderson, Board Member's Office, Fourth District	
Mr. Lee Williams, Board Member's Office, Second District	
Mr. Ken Maddox, Board Member's Office, Third District	
Mr. Neil Shah, Board Member's Office, Third District	
Ms. Elizabeth Maeng, Board Member's Office, Third District	
Ms. Christina Rueck, Board Member's Office, Third District	
Ms. Natasha Ralston Ratcliff, State Controller's Office	
Mr. Ramon J. Hirsig	
Ms. Kristine Cazadd	
Ms. David Gau	
Mr. Jeff Vest	Mr. Phil Bishop
Mr. David Levine	Mr. Todd Gilman
Mr. Randy Ferris	Ms. Laureen Simpson
Mr. Robert Lambert	Mr. Robert Ingenito Jr.
Ms. Carolee Johnstone	Mr. Bill Benson
Mr. Brad Heller	Mr. Geoffrey E. Lyle
Mr. Bill Kimsey	Ms. Leila Hellmuth
Mr. Dave McKillip	

# INITIAL DISCUSSION PAPER

## Proposal for New Regulation 4076, *Wholesale Cost of Tobacco Products*

### Issue

Should a new regulation be adopted that would clarify how distributors should determine the wholesale cost of the tobacco products they distribute and how the Board of Equalization (Board) may determine the wholesale cost of tobacco products in those situations where a distributor has not reported accurate wholesale cost amounts on which the calculation of the tax due is based?

### Background

This issue involves the proper calculation of a distributor's "wholesale cost," as defined in Revenue and Taxation Code section (Section) 30017 of the Cigarette and Tobacco Products Tax Law,<sup>1</sup> which provides: "'Wholesale cost' means the cost of tobacco products to the distributor prior to any discounts or trade allowances." The amount of tax due on tobacco products under this law is determined by multiplying the tax rate times the wholesale cost of these products. (Rev. & Tax. Code, § 30123, subd. (b).) The Board has collected the tax on tobacco products based on the wholesale cost of these products for 20 years, despite the fact that the statutory definition of "wholesale cost" provides little guidance as to how the wholesale cost of a tobacco product should be determined. Proposed Regulation 4076 codifies the Board's longstanding practices with respect to the proper determination of a distributor's wholesale tobacco products cost before discounts or trade allowances.

The need for regulatory clarification is exemplified by issues and arguments put forward in *U.S. Smokeless Tobacco Brands, Inc. v. State Board of Equalization* (Super. Ct. San Francisco County, 2009, No. CGC 07-463592, appeal pending) (UST case). In this case, the plaintiff, U.S. Smokeless Tobacco Brands, Inc. (Plaintiff), has argued that the amount of wholesale cost it should report to the Board is the amount Plaintiff reports to the Internal Revenue Service as the "transfer price," an allocation for the purchase of tobacco products from its sister subsidiary company, UST Manufacturing. However, this "transfer price" is considerably lower, as much as 82 percent lower, than previous wholesale cost amounts that Plaintiff reported for similar products prior to UST Company, Inc.'s division into these two subsidiary companies. The Board argues that the "transfer price" between the two subsidiary companies is the price after discounts have been applied, not the wholesale cost as defined in Section 30017, and is, therefore, not an accurate measure for determining the correct amount of tax due. In sum, Plaintiff's method of determining wholesale cost is contrary to the Board's longstanding practices with regard to calculating the proper measure of tax and, under the Cigarette and Tobacco Products Tax Law, constitutes an attempt to exclude discounts from the taxable measure through an improper transfer pricing scheme.

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<sup>1</sup> Part 13 (commencing with section 30001) of Division 2 of the Revenue and Taxation Code.

# **INITIAL DISCUSSION PAPER**

## **Proposal for New Regulation 4076, *Wholesale Cost of Tobacco Products***

Other problematic industry practices that proposed Regulation 4706 is intended to address include, in addition to intra-company transactions: other types of related party transactions, as defined in the draft regulation; reporting of costs as "wholesale costs" that include unstated discounts; failure of the distributor to provide the Board with complete, accurate, and reliable information and data as to its "wholesale costs"; and the failure to accurately report the "wholesale cost" of free samples given to the distributor at an effective 100 percent discount.

### **Proposed Regulation**

Staff recommends that the Board adopt a regulation to clarify how all distributors should determine the wholesale cost of the tobacco products they distribute and how the Board may determine the wholesale cost of tobacco products, including, but not limited to, situations where a distributor has not reported accurate wholesale cost amounts under Section 30017 (e.g., by reporting cost *after* any discounts or trade allowances allowed to the distributor). By explicating the Board's longstanding practices, proposed Regulation 4076 clarifies the factors that are to be considered when determining the wholesale cost of tobacco products under various circumstances and specifies how those factors shall be implemented.

### **Summary**

Staff proposes that the Board adopt new Regulation 4076: (1) to clarify how distributors should determine the wholesale cost of tobacco products they distribute, before discounts or trade allowances, and how the Board may determine wholesale cost, before discounts or trade allowances, where a distributor has not reported accurate wholesale cost amounts; (2) to implement, make specific, and carry out the terms and provisions of Section 30017 with respect to related party transactions; (3) to preclude improper attempts to exclude discounts from the taxable measure through transfer pricing schemes; and (4) to clarify that there is no "gap" or inconsistencies between the Board's longstanding practices and the proper interpretation of Section 30017's definition of "wholesale cost."

Prepared by the Legal Department and the Property and Special Taxes Department

Current as of 1/5/10

**\*\*DRAFT\*\***  
**\*\*FOR DISCUSSION PURPOSES ONLY\*\***

**CIGARETTE AND TOBACCO PRODUCTS TAX LAW REGULATION 4706**  
**(Part 13 of Division 2 of the REVENUE AND TAXATION CODE Section 30001 et seq.)**

Title 18. Public Revenues

Division 2. State Board of Equalization – Business Taxes

CHAPTER 9. CIGARETTE AND TOBACCO PRODUCTS TAX LAW REGULATIONS

**Regulation 4076. Wholesale Cost of Tobacco Products.**

**(a) Definition of terms.** The following definitions shall apply for purposes of this regulation:

- (1) **Arm’s-length.** An “arm’s-length” transaction means a purchase or other business transaction entered into in good faith and for valuable consideration that reflects the fair market value in the open market between two informed and willing parties, neither under any compulsion to participate in the transaction.
- (2) **Discounts or trade allowances.** “Discounts or trade allowances” means and includes any discounts, price reductions, or allowances of any kind made by the supplier in setting a price, including, without limitation, any discounts applied to a supplier’s price list, such as for prompt payment, payment in cash, bulk purchases, or favored customer status.
- (3) **Distribution; distribute.** “Distribution” and “distribute” mean: (A) the sale of untaxed tobacco products in the state; (B) the use or consumption of untaxed tobacco products in the state; or (C) the placing of untaxed tobacco products in retail stock in the state for the purpose of selling the tobacco products to consumers.
- (4) **Distributor.** “Distributor” means every person that: (A) distributes tobacco products; or (B) sells or accepts an order for tobacco products that are to be transported from a point outside the state to a consumer within the state.
- (5) **Finished tobacco products; finished condition.** “Finished tobacco products” and tobacco products in “finished condition” mean and include tobacco products that will not be subject to any additional processing before first distribution in the state.
- (6) **Production; produce; processing.** “Production,” “produce,” and “processing” mean and include a fabrication process, or a step in a fabrication process, leading to the production of a finished tobacco product.
- (7) **Profit.** “Profit” means the positive gain from an investment or business operation after subtracting all costs and expenses determined in accordance with generally accepted accounting principles.

- (8) **Similarly situated distributors.** “Similarly situated distributors” means distributors operating under reasonably similar economic and market circumstances.
- (9) **Supplier.** “Supplier” means any manufacturer, seller, or transferor that sold or transferred tobacco products to the distributor whose wholesale costs are being determined.
- (10) **Tobacco product costs.** “Tobacco product costs” means and includes the cost of tobacco products to the distributor, determined as set forth below in paragraph (d), as of either (A) the date the distributor acquires finished tobacco products or (B) the date the distributor completes production of finished tobacco products.
- (11) **Tobacco products.** “Tobacco products” includes, but is not limited to, all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing at least 50 percent, tobacco, but does not include cigarettes.
- (12) **Wholesale cost.** “Wholesale cost” means tobacco product costs, prior to and exclusive of any discounts or trade allowances; but excluding the cost of tobacco products that were returned by a customer during the same reporting period in which the tobacco products were distributed if the distributor refunds the entire amount the customer paid for the tobacco products either in cash or credit. For purposes of this subparagraph, refund or credit of the entire amount shall be deemed to be given when the purchase price less rehandling and restocking costs is refunded or credited to the customer. The amount withheld for rehandling and restocking costs may be a percentage of the sales price determined by the average cost of rehandling and restocking returned merchandise during the previous accounting cycle.

**(b) Presumption – not-at-arm’s length.** Sales, purchases, and transfers of tobacco products between and among relatives (by blood or marriage, which relationships include, but are not limited to, spouses, parents, children and siblings), a partnership and its partners, a limited liability company or association and its members, a corporation and its shareholders, and persons, as defined in Revenue and Taxation Code Section 30010, and entities under their control, are rebuttably presumed to be not-at-arm’s-length transactions. If the Board determines that a sale, purchase, or transfer was between or among any of the related parties set forth in this paragraph, the distributor may rebut the presumption only by showing by clear and convincing evidence that the transaction was, in fact, at arm’s length or, alternatively, that the terms and conditions of the transaction were substantially equivalent to those that would have been negotiated between unrelated parties in an arm’s-length transaction.

**(c) Calculation of the taxable wholesale cost of tobacco products.** For purposes of the tax set forth in Revenue and Taxation Code Section 30123, subdivision (b), and Section 30131.2, subdivision (b), the taxable wholesale cost of tobacco products shall be the “tobacco product costs,” as determined pursuant to subdivision (d) below, exclusive of any discounts or trade allowances.

**(d) Calculation of tobacco product costs.** The Board shall determine tobacco product costs in accordance with the following:

- (1) **Standard methods for determining tobacco product costs.** Except as provided in paragraphs (2) and (3) below, tobacco product costs shall be determined as follows:

(A) **Tobacco product costs to a distributor that acquires finished tobacco products from a supplier.** When a distributor acquires tobacco products in finished condition from a supplier, tobacco product costs shall be equal to the cumulative costs paid or incurred by the distributor for and with respect to the acquisition of the finished tobacco products, exclusive of freight-in costs.

(B) **Tobacco product costs to a distributor that produces finished tobacco products.** When a distributor produces finished tobacco products, tobacco product costs shall be equal to the sum of all direct and indirect costs that the distributor paid or incurred with respect to the production of finished tobacco products. Such costs include, without limitation, all of the distributor's outlays and expenditures, such as amounts paid to suppliers for raw tobacco, the costs of overhead, labor, other materials, and their related freight-in costs, paid or incurred in the production process, and the costs of marketing the finished tobacco product to customers and prospective customers.

(C) **Tobacco product costs to a distributor that imports tobacco products or finished tobacco products from outside the United States.** In addition to the costs described in subparagraphs (A) and (B) above, a distributor's tobacco product costs for finished tobacco products that the distributor acquires or produces shall also include customs fees and federal excise taxes on finished tobacco products and tobacco products that the distributor imports from outside the United States.

(D) **Tobacco product costs to a distributor that acquires finished tobacco products free of charge, or as a free sample, from a supplier.** Where a distributor acquires finished tobacco products free of charge, or as a free sample, from a supplier, the distributor shall be considered to have acquired the finished tobacco products at a 100 percent discount. In such event, the board, in its sole discretion, may determine the tobacco product costs of those finished tobacco products in accordance with one or more of the alternative methods for determining tobacco product costs set forth in paragraph (3) below.

(2) **Addition of discount and trade allowance amounts to tobacco product costs to calculate wholesale cost.** If the board determines that, instead of reporting wholesale costs, the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances, and complete and reliable information is available to the board allowing it to reasonably estimate the amounts of such discounts or trade allowances, then the board may rely upon such information to reasonably estimate the distributor's wholesale costs, prior to and exclusive of discounts and trade allowances, by adding such estimated discount and trade allowance amounts to the tobacco product costs reported by the distributor or otherwise determined under paragraph (1).

(3) **Alternative methods of estimating or calculating tobacco product costs.**

(A) If the board determines that (i) the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances and complete and reliable information sufficient to reasonably estimate the amounts of such discounts or trade allowances is not available to the board or (ii) the distributor purchased or acquired tobacco products in one or more not-at-arm's-length

transactions, then the board may, in its sole discretion, determine tobacco product costs by relying upon one or more of the methods set forth in subparagraphs (B) and (C) below.

- (B) The board may rely upon a publicly or commercially available price list that the distributor used to determine the prices of tobacco products sold to customers in arm's-length transactions during the time period at issue, less a reasonable estimate of the distributor's profit.
- (C) If a publicly or commercially available price list is not available to the board, the board may reasonably estimate tobacco product costs by relying upon industry data from the time period at issue that provide reasonable evidence of typical or normal tobacco product costs during the time period at issue, including, without limitation: (i) evidence reasonably indicative of the typical costs of the same or similar tobacco products for similarly situated distributors, with appropriate adjustments to such costs as indicated by all the facts and circumstances; or (ii) all the direct and indirect costs that the supplier paid or incurred with respect to acquisition, production, marketing, and sale of the tobacco products sold by the supplier to the distributor, with appropriate adjustments to such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit; or (iii) the price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances; or (iv) the retail price of the same or similar tobacco products as reflected in a retailer's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances, less reasonable estimates of the retailer's and distributor's profits.

**(e) Examples:**

- (1) **Example 1:** Distributor A purchases a finished tobacco product from a domestic supplier in an arm's-length transaction. A's wholesale cost of the tobacco product is the amount A paid to the supplier for the tobacco product, exclusive of any freight costs, discounts, and trade allowances.
- (2) **Example 2:** Distributor B produces handmade cigars. B's tobacco product costs include all of the direct and indirect costs that B paid or incurred with respect to the production, packaging, and marketing of the cigars.
- (3) **Example 3:** Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the board presumes that the sale and purchase were not at arm's length, and the presumption is not rebutted by C. If a publicly or commercially available price list that C used during the time period to determine its prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of C's profit, to estimate C's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly



situated distributors less a reasonable estimate of distributor profits, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in paragraph (d)(3).

- (4) **Example 4:** Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. The board determines that D acquired such tobacco product at a 100 percent discount or trade allowance. If a publicly or commercially available price list that D used during the time period to determine its sales prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of D's profit, to estimate D's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of distributor profits, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in paragraph (d)(3).
- (5) **Example 5:** Distributor E acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the costs of all customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.

Note: *Authority:* Section 30451, Revenue and Taxation Code. *Reference:* Sections 30008, 30010, 30011, 30017, 30121, 30123, and 30131.2, Revenue and Taxation Code.